COOPER WEALTH MANAGEMENT
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THOUGHTS FROM HOME

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The Balancing Act

"There is a vast difference between keeping out of war and pretending the war is none of our business."
-- Franklin D. Roosevelt, 1940 State of the Union

Roosevelt made this speech at the start of World War II before the fall of France. After the horrors of World War I only 20 years before, the American public had no interest in being involved in another war. The attack on the Ukraine and the resulting devastation puts the U.S. and its NATO allies in a similar position. They are supporting the Ukrainian people with arms, supplies and sanctions but not direct military intervention. Fortunately, modern warfare is fought as much with economics as weapons. The balancing act for NATO is to try and end the war without direct involvement as quickly as possible while minimizing the impact on the global economy, particularly inflation. This month, we will focus on the Ukrainian crisis and its effects on global financial markets.

Russia's economy is comparable to Canada in size and resource focus. They are a major exporter of several key commodities including oil, natural gas, coal, wheat, fertilizer, aluminum and copper. Since the war started, these prices have all spiked higher as most Russian goods except oil, gas and wheat are now subject to severe NATO sanctions. One of the key issues is that the European Union relies on Russia for 35% of its natural gas supply, with a third of that volume coming through pipelines in the Ukraine. Currently, world supply of these commodities is not enough to cover demand if Russia is sanctioned out of the market. Countries who normally did business with Russia are reluctant to do so now because sanctions have limited both their ability to deliver goods and to make or receive payment. Also, few are willing to risk the reputational damage at this time. Even China, though it has not imposed sanctions, has publicly asked for this war to end.

Unfortunately, there are no easy short term answers. Germany has announced they will build two new liquid natural gas plants to reduce future reliance on Russia but that will likely take 5-10 years to complete. While the situation continues, commodity prices will remain elevated and keep upward pressure on inflation. We added two energy positions last month: Tourmaline for natural gas and Suncor for oil. Once the war ends, we expect oil to fall from the current $115 per barrel back to the pre-war $80-90 level, which will relieve some pressure on inflation but don't expect it to fall further until additional production comes on line.

Whenever there is global unrest, investors look for shelter in the U.S. dollar, which has risen sharply against all currencies in the last two weeks. Buying pressure on the 10 year U.S. Treasury bond has seen the yield fall from 1.95% to 1.72% as the crisis continues. More importantly, the closely watched 2-10 year yield spread has narrowed to only 25 basis points, which basically means you get almost the same return for investing for two years or ten. U.S. Federal Reserve Chairman Powell has indicated he intends to proceed with a 25 basis point rate increase in March. We also believe they will begin to sell their Treasury bond holdings in an effort to try to raise the ten year yield and steepen the yield curve. The reaction of the bond market will be crucial. If the ten year yield does rise, more U.S. rate increases are likely coming but if the yield curve stays as is, or if short rates move even higher, further rate increases would likely be placed on hold and we would expect to see a significant rally in U.S. stocks, particularly in the technology names. The key factors here are how long will the war last and what does the global post war economic scenario look like.

Russia may be gaining ground in the Ukraine but it is losing ground at home. The Russian stock market has been closed and will remain so until at least March 9th and share prices are down 75-95%. The ruble has fallen 40% and interest rates are down 20%. Russians can't travel, ship or receive goods, their stores are emptying, they cannot use their credit cards and have only restricted access to cash, all due to NATO sanctions. This is nothing compared to the suffering of the Ukrainian people but the impact on the Russian economy will be felt for years to come. Hopefully the pressure on Russian leadership will be sufficient to shorten the war.

So what will curb global inflation? Raising North American interest rates will have a disproportionate impact on the lowest income households that have the least amount of discretionary spending and smallest impact on GDP. Major companies will only feel an impact if spending actually slows. It is our belief that raising interest rates only makes both the U.S. and Canadian dollar even safer havens for international investors and given the chaos from the war, we will continue to attract investment dollars which will keep downward pressure on yields, as it is increasing unlikely the European Union would raise interest rates during the war or in its immediate aftermath until the damage to the Ukraine and the cost of necessary repairs can be assessed. Raising rates will certainly not be their first priority.

Our outlook is that commodity driven inflation will be with us for some time, at least until further supply comes on line. In the short term, inflation will remain higher while the war continues and the possibility of sanctions on Russian oil remains. We expect some of this inflation will naturally ease as global demand shifts from consumer goods to travel and leisure in a post Covid and post war world but timing remains uncertain.

In the meantime, North American markets have held up reasonably well. Canadian stocks, particularly energy and natural resources, have performed well while many U.S. companies have little exposure to Russia. We will likely add more commodity exposure to the portfolio but only after the crisis ends and some further certainty returns. We also expect a moderation of interest rate increase expectations to give a significant boost to U.S. equities, particularly technology.

In closing, the world is out of balance at the moment. Inflation is a minor concern compared to the humanitarian costs of war but we can't forget about the future while we worry about today. We continue to monitor global developments and make necessary changes as required. Until next month, our thoughts and prayers are with the Ukrainian people.
As always, thoughts, concerns, and feedback are always welcome.

Yours truly,

Trevor, Walter and the Cooper Wealth Management team